From:	Justin Mondshine <Justin@pointstate.com>
To:	Ehud Barak (ehbarak1@gmail.com) <ehbarak1@gmail.com>
CC:	Zach Schreiber <Zach@pointstate.com>
Date:	Thu, 9/4/2014 11:38:51 PM
Subject:	FW: Eurasia Group Note - IRAN - Deal on the nuclear issue is nowimprobable

Ehud,

Can we set aside a time to discuss the issues raised in the below piece? I think the author lays out a convincing argument for why a deal is unlikely on balance (still wide bid-ask on # of centrifuges, no apparent preparation of Iranian elite for a deal, more hawkish rhetoric from Khamenei, strengthening of the IRGC and other hardliners at the expense of Rouhani and his supporters) but he also believes that no deal by Nov 24 means that the chance for a deal would effectively end for the foreseeable future as the US Congress imposes additional sanctions and the hawks on both sides begin to gain the upper hand. It's that last part I'd like to focus on as I believe that view differs from yours – mainly that we can remain engaged in discussions even as the Nov 24 deadline passes without resolution as discussions are in everyone's interest.

Hope you found your China trip productive. Would love to hear about it.

Best,

Justin

From: Kupchan, Cliff [mailto:kupchan@eurasiagroup.net]
Sent: Thursday, September 04, 2014 2:19 PM
To: Justin Mondshine
Subject: Eurasia Group Note - IRAN - Deal on the nuclear issue is now improbable

IRAN

Short-term trajectory: **Negative** Long-term trajectory: **Negative**

Deal on the nuclear issue is now improbable

4 September 2014 01:55 PM EDT

• Primarily because the sides are at an impasse over the size of Iran's enrichment capacity, Eurasia Group now believes that a final deal is unlikely.

• However, this remains a very close call and last minute agreement is possible.

• Diplomacy's failure would ramp up geopolitical tensions, and bring a US move to significantly reduce Iran's current oil exports by tightening secondary sanctions.

As talks between the US and Iran resume on 4 September, Eurasia Group takes a more pessimistic prognosis for diplomacy. The dispute over Iran's enrichment capacity, increasingly hard line Iranian rhetoric, and the US' unwillingness and political inability to show more flexibility lead us to believe the sides will not reach an agreement before the 24 November deadline. We now assign a 40% chance of a deal, down from our previous 60% call. Another extension of diplomacy is unlikely, as hawks on both sides would act to bring this sequence of talks to a close. A "no deal" outcome would involve harsh new sanctions, a weakening of the centrist government of President Hassan Rouhani, and increased geopolitical risk. We have downgraded our trajectories for Iran from neutral in the short-term and positive longer-term to negative in both timeframes.

Why a deal is unlikely

The core reason for our new skepticism is that on the bellwether issue of Iran's enrichment capacity under a final deal, Iran's position has not changed during six months of talks. Enrichment capacity, the number and sophistication of Iran's centrifuges, is at the very core of the talks; the most advanced aspect of Iran's nuclear program is uranium enrichment, and Iran's advances in this realm have created short breakout times and western concern that Iran seeks a bomb. The US-led P5+1 insist that Iran have at most 5,000 IR1s, or the equivalent enrichment capacity involving a more advanced machine, in a final deal. On 13 July, Supreme Leader Ali Khamenei stated (surely incorrectly) that the west had offered Iran roughly 10,000 machines enriching uranium under a final agreement. That statement created a de facto red line among Iran's elite. In addition, top Iranian elites have consistently said Iran is not willing to dismantle centrifuges to reach an agreement, suggesting that the roughly 9,000 machines Iran currently operates under vacuum would also have to remain in place. Conceivably Khamenei could break the red line over the coming 2.5 months, but that would create a severe backlash among conservatives.

In addition, Iran is chafing at US demands for long-term constraints on Iran's centrifuge R&D program. Ali Akbar Salehi, the head of Iran's nuclear program, on 27 August said that Iran was ready enrich uranium in the "IR8," an advanced machine allegedly 24 times more powerful than Iran's operational IR1. While Salehi's claims were almost surely bluster, Iran takes great pride in its scientific prowess and is unlikely to accept severe and long-term constraints on it. Finally, the sides disagree on the duration for which constraints on Iran's program would last, the nature and extent of sanctions relief Iran would receive up front, and on other issues. Creative diplomacy could solve the latter matters, but enrichment is a true deadlock.

An additional reason for our increased pessimism is that the Iranian leadership is not preparing its elite for a deal. To the contrary, statements by top officials have become considerably harsher over the past two months. On 13 August, Khamenei stated that a year of nuclear talks with the US has produced no benefit for Iran; to the contrary, the US keeps imposing sanctions and making harsher demands. In unusually strong terms, he suggested that dealing with the US was in general pointless. In the context of this speech, Khamenei's ongoing support for the nuclear talks seems increasingly perfunctory. And in his 7 July speech, Khamenei said Iran in the future would need the equivalent of 190,000 centrifuges; though he was not specific in the timeframe, he's hardly curbing elite expectations for the nuclear program. Rouhani, meanwhile, on 30 August gave press conference in which he was guarded about prospects for the nuclear talks, saying the US many not have sufficient good will to resolve the issue. The president might truly hold this view, or he may have been pitching to the restless hard liners - in either case, his words are worrisome. Also, Iran's current economic forecasts assume continued sanctions in another sign that top officials are not preparing the country for an agreement.

Moreover, aspects of Iranian domestic politics threaten consummation of a deal. The main concern is the Revolutionary Guards (IRGC), who are opposing the inspection, monitoring, and verification aspects of a potential agreement. The IRGC do not want western inspectors having wide access, for years, to their military bases. More broadly, senior IRGC commanders surely resist long-term constraints on the nuclear program. The political clout of the IRGC has risen in recent months, as the Iranian elite and public view the IRGC as the ultimate protector against ISIS. A security-oriented group of secular hard liners, "the concerned," also oppose a deal.

In addition, signs are appearing that Rouhani's strength has begun to diminish. On 20 August, Reza Faraji-dana, a liberal minister of science and higher education, was impeached and removed from office by hard liners. The move was a blow to Rouhani, and suggested hard liners have recovered some ballast. The government has suffered a number of setbacks at the hands of the judiciary in the realms of social freedoms. Finally, Eurasia Group sources report increasing concern within the government itself about the fate of the nuclear talks.

The greatest risk for Iran in its looming acceptance of a no deal outcome pertains to the fate of its economy. If diplomacy fails, the US will attempt to take off line through secondary sanctions a significant portion of the roughly 1.2 million barrels per day (bpd) of crude and condensate that Iran still exports. Additional Iranian sectors would be sanctioned, and more restrictions on trade would be enacted. In our view, Iran's economy would over a few years become a threat to

political stability.

But Khamenei and other Iranian elites may well not see it that way. Khamenei is not steeped in economics, and his information comes from the office of the supreme leader - which is dominated by current and former IRGC members. They may well be arguing that an autarchic economy can work. Also, top Iranian leaders have stated that the sanctions regime is cracking. In his recent presser, Rouhani said that if talks fail, sanctions will wither. On 9 August, deputy head of Iran's nuclear team Abbas Araqchi stated that "sanctions have seriously cracked."

Moreover, the Russia-Ukraine conflict and Russia's break with the US may be another motivating hope for the economy in a no deal scenario. On 6 August, Russia and Iran signed an MOU under which Russia would buy some Iranian crude and Iran in turn would potentially buy additional reactors, oil and gas equipment, other machinery, and food from Russia. We do not believe Putin will consummate the deal any time soon, as that would bring down the wrath of even more sanctions on Russia. But hard liners can now use the MOU that the economic effects of "no deal" can be mitigated.

In sum, Khamenei appears willing to opt for a "no deal" economic and political trajectory if the alternative is to forgo the political legitimacy that the nuclear program affords him and risk the support of his conservative base. He fears that even in the context of a nuclear deal, the US will keep pressuring Iran on other issues - including via sanctions.

The evolution of US policy has also created challenges to a deal. The US administration could not accept more than about 5,000 Iranian centrifuges even if it were so inclined, as the Congress is convinced that a larger number would give Iran an unacceptably short breakout time. Congressional repeal of any sanctions, especially if the Republicans control at least one chamber, would be very difficult - even in the medium to long-term. And very powerful US think tanks and interest groups oppose a deal. Domestic politics in both the US and Iran have evolved into significant obstacles to a deal.

If there is no agreement by 24 November, the chance for a comprehensive agreement would end, at least for the foreseeable future. The US Congress would very likely pass harsh new sanctions in short order, and Iran would resume intensive work on the most threatening aspects of its nuclear program. It's very likely that tensions would escalate quickly. Some sporadic talks may well continue - as neither government will want to walk completely away. The two governments may seek a period of mutual and unilateral restraint, in which the US applies only modest new sanctions and Iran makes limited advances in its nuclear program. But the US Congress is not likely to hold back on sanctions, and this restrained scenario carries a low probability.

The market effects of "no deal"

The failure of diplomacy would have significant market effects. The US would move to take sizeable numbers of Iranian barrels of the market, bringing Iran well below 1.2 million bpd. We believe that sentiment in the US Congress over diplomacy's failure would be the main force behind US policy, and that the Obama Administration could not stop the legislative train, even if it chose to try. The US would impose further reductions over the course of perhaps a year, with the stated goal of coercing Iran back to the talks. Two somewhat exclusive goals would drive US policy. Reducing oil exports is the most effective way to crimp Iran's economy. But extremely aggressive and draconian sanctions could split the coalition behind sanctions. As a result, US policy will be aggressive but modulated.

China would be the wild card in determining how much additional volume comes off. We believe that Beijing, which currently imports roughly 600,000 bpd from Iran, would significantly reduce volumes under a new sanctions regime. But we do not yet have a firm view on whether China would for political reasons defy the US and maintain some level of Iranian imports. The Saudis could supply most of the lost volumes to market -- in an environment where they would otherwise be moving toward production restraint. But Saudi spare capacity would fall to levels that the market considers dangerous.

Israel would be very alarmed should diplomacy fail, and the chance of Israeli strikes would rise

and further rattle markets. We would assess the chance of Israeli strikes in this scenario at about one in four; many influential Israeli elites do not believe Israel alone can significantly set back Iran's nuclear program, and on balance we do not believe Israel would attack. Regarding a US-initiated strike on Iran, we believe the chances are very low, as President Obama is very averse to entangling the US in another war in the region. However, if Israel attacks, the US may well get drawn in.

Finally, if Iran again gears up its nuclear program, as is likely, Saudi Arabia will either buy a nuclear weapon or lead the world to believe it has acquired one.

This constellation of risks would apply upward pressure on the oil price.

Why a deal is still possible

However, Iran could still in the end agree to a deal (again, a 40% chance). Iran's leadership could be waiting until the last minute to see the US' last, best offer. Indeed, Iran's negotiating style is one of brinksmanship, making any significant concessions only at the last minute. The current hard line rhetoric could primarily represent at attempt to gain leverage at talks. The structural arguments that underlay our previous call still very much apply; both sides would have significant troubles living in a "no deal" world. Iran desperately needs sanctions relief for an economy that has entered stagflation. And the US wants to avoid the choice between accepting a nuclear-weapons capable Iran and risking another war in the Middle East. Finally, if on the margins, ISIS draws the sides closer together, in that it presents a severe and common threat even if the US and Iran don't directly cooperate.

Specific signposts would again lead us to expect a deal in November, should most of them be checked. We would need to see concrete signs that Iran is willing to dismantle many centrifuges, and live with a symbolic number of them for many years. Iran would have to prepare its elite for an agreement. If Iran were to return to language stating that it needed a deal to maintain its economy, that would be an encouraging signpost. Finally, if the US finds a politically viable way to become more flexible on substance, the chance of a deal would go up.

But barring a change of course by Iran, we now do not expect a final agreement.

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- **Positive:** Political factors in the country are anticipated to lead to a more favorable macro business environment
- **Neutral:** Political factors in the country are anticipated to have a neutral or negligible impact on the macro business environment

- **Negative:** Political factors in the country are anticipated to have a negative impact on the macro business environment

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